Viewpoint

A New Regime in European Credit

June 2018

As volatility rises and the beta rally draws to a close, how can investors seek to strike a balance between return maximisation and drawdown protection?

In our view, the fundamental backdrop in European high yield remains strong and investors should continue to benefit from the attractive carry available. The high yield market is less levered, better rated and has greater interest coverage ratios on average than at any time in the past several years.[1]

Having said that, 2018 is turning into a year of transition as the market begins to contemplate life after ECB quantitative easing (QE). Rising rates, plateauing or rising credit spreads and increased volatility are returning to credit markets.

We believe that, in this context, active management and stock picking will once again come to the fore and managers will need the full suite of investment tools at their disposal to transition smoothly into a new regime.

Extraordinary central bank measures have had a profound effect on risk assets over the last two years. From our observations in the credit market, spread dispersion was all but erased and bottom-up credit selection was not necessarily rewarded.

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1. Source: Deutsche Bank, Moody's, BofA Merrill Lynch, as of April 30th 2018.

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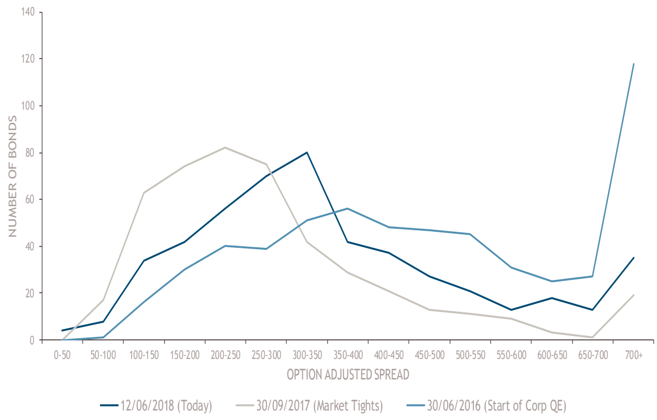
As we begin the slow process of withdrawal from these extraordinary measures, we believe it is inevitable that dispersion rises from historically low levels and credit selection becomes a meaningful differentiating factor. Identifying the good credits from the bad will once again drive returns.

Fig. 1 – Spread Dispersion Rising from Lows

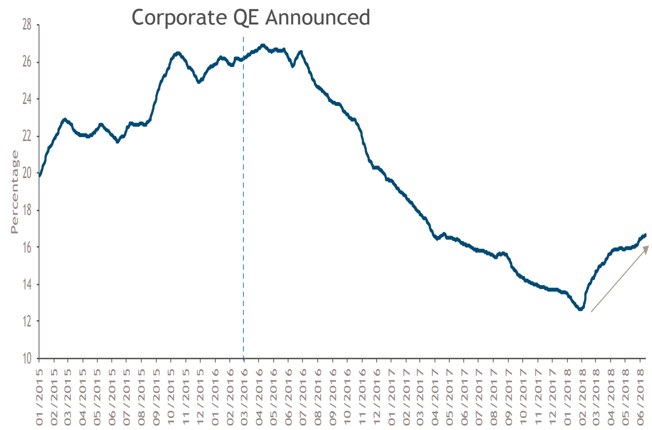


Source: BofA Merrill Lynch HE00 European HY Index, as of 12 June 2018.

The above chart illustrates that most bonds traded in a narrow spread range at the extreme tights of the credit market at the end of Q3 2017 (grey line). We are now seeing the beginning of a normalisation (today's situation in dark blue) as bond spreads move to reflect a diverse fundamental picture. From here we anticipate particular room for the tail of credits with very large spreads to grow to a level more in-line with historical norms (pre-QE in light blue).

Likewise, we consider the market reaction to episodes of political or macroeconomic risk will no longer be dampened by ECB support, and as a result there are likely to be more prolonged bouts of volatility. Indeed, we believe we are already seeing signs of this (Fig. 2).

Fig. 2 – Volatility Levels Set to Rise

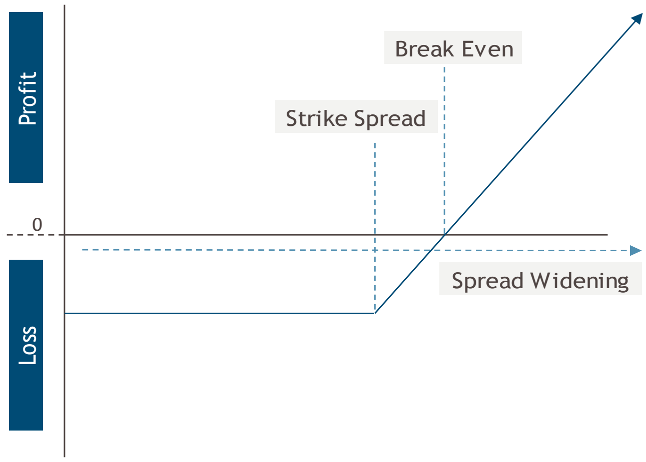


Source: VSTOXX 100 day moving average. Muzinich & Co, views and opinions for information purposes only, not an offer to buy or sell or invitation to engage in any investment activity. As of June 11th, 2018.

As volatility returns, investment strategies with the ability to put in place strategic and tactical hedges could provide better risk-adjusted returns than their more constrained counterparts. We think having structural portfolio protection in place makes sense here and one interesting way to do that is via credit options (Fig. 3).

Comforting though it is, this portfolio protection does not come without a cost, and we believe finding a way to finance it and to prevent too great a drag on portfolio returns is key.

Fig. 3 – Out of the Money Credit Option Dynamic Hedging



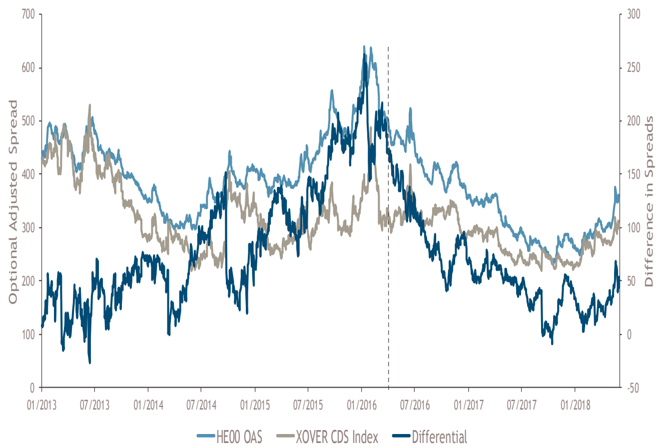
Source: Bloomberg and Muzinich analysis. For illustrative and discussion purposes only, not an offer to buy or sell or invitation to engage in any investment activity.

Investors with a flexible mandate and access to investment tools other than bonds may generate alpha to offset the cost of these hedges.

One example of this flexibility would be the ability to invest either via credit default swaps (CDS) or bonds.

Derivatives such as CDS can be used in a number of ways in seeking to enhance returns. As Fig. 4 highlights, CDS are at historically cheap levels relative to the cash bond market and choosing the instrument with the greatest total return potential may lead to meaningful alpha generation over a pure bond strategy.

Fig. 4 – High Yield Cash Spreads versus CDS

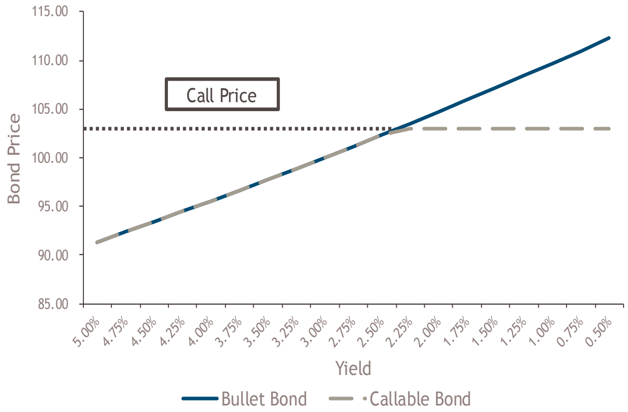


Source: Bloomberg and Bank of America Merrill Lynch. Data as of June 12th, 2018. ICE BofA European High Yield Index (HE00), XOVER CDS - Markit iTraxx European Crossover Index.

The ability to invest via CDS is particularly interesting in the high yield market due to the callability of high yield bonds. Embedded call options are a common feature of many high yield bonds (70% of the market – source: BofA Merrill Lynch, HE00 as of 15th June 2018).

This means that they are unable to participate fully in any spread rally as the call option can be exercised by the bond issuer, thus limiting bond price appreciation. CDS, on the other hand, behave in a similar way to bullet bonds and can therefore continue to appreciate, providing additional convexity (Fig. 5).

Fig. 5 – Bullet Bonds and CDS May Offer More Opportunities for Price Appreciation



Source: Bloomberg and Muzinich analysis. The above example is based on two bonds illustrated as having the same coupon and maturity - 3% coupon, 5-year maturity, callable at 103 anytime, 3% coupon, 5-year maturity, bullet. For illustrative and discussion purposes only, not an offer to buy or sell or invitation to engage in any investment activity. This should not be construed as an investment recommendation.

A further way of generating alpha is to seek returns from sources which do not rely on market direction. We believe that distortions created by QE, for example the historic low levels of spread dispersion, have resulted in an opportunity-rich environment for arbitragers.

In our view, unnaturally close relationships between credits of varying quality, or clearly distorted credit curve shapes, should begin to normalise and bring profits to those positioned to exploit these abnormalities.

Using the tools outlined above, as the regime shifts and the market finds a new equilibrium for risk assets without the prop of QE, we believe active managers can navigate this transitional period effectively and that there remains a place for European high yield exposure as a core holding of investors' portfolios.

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Market Index Descriptions:

HE00 - The ICE BofA ML Euro High Yield Index tracks the performance of EUR dominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody’s, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

The ITRAXX Europe CDS Crossover Index is comprised of 45 equally weighted single company credit default swaps. Companies included in the index are based in Europe and are rated sub - investment grade at the time of index inception.